RE: File No. S7-19-07 Amendments to Regulation SHO

NIPC

National Investor Protection Coalition

1452 South Rimpau Ave., Suite 108, Corona, Ca 92879
www.Investorprotectioncoalition.org

"Advocates for the Protection of Equity Securities Investors and Issuers"

RE: File No. S7-19-07 Amendments to Regulation SHO

August 13, 2008

Ms. Florence E Harmon
Acting Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Dear Ms. Harmon:

We are pleased that the SEC has released the fail to deliver analysis conducted by the OEA, which concludes that options market makers are the cause of many "fails to deliver", as well as the recent sharp increase in the number of "fails to deliver" [1]. We are also heartened that the SEC issued an emergency order [2] requiring a pre-borrow and adherence to the settlement cycle. This emergency order is an admission by the Commission that there exist severe systemic risks created by the current regulatory scheme, which are now obviously manifesting in the securities markets[3]- exactly as we have been telling the Commission for years [4]. It is clear that the most effective ingredient in the emergency order is the reminder that delivery of securities is required by the settlement date, as legally defined in the settlement cycle rule [5].

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We Request The Proposed Amendment To Rule 200(g) Be Adopted

We strongly urge the commission to amend rule 200(g) as proposed, to force proper documentation of "locates", as we cannot imagine proper enforcement of the locate requirement in REG SHO unless there is meaningful documentation proving that brokers are properly locating shares before short selling them. If brokers properly document their "locate" of shares for short sales [6], then subsequent failing to deliver would expose any nefarious motive, enabling the commission to easily determine intent, thereby making the 10b anti-fraud and ant-manipulation rules effective enforcement tools. Without being able to establish intent, the 10b rules are ineffective, making enforcement action against illegal naked short sellers very difficult.

We Request The Complete Elimination of the Market Maker Exemption

The conclusion of the OEA analysis settles the argument of whether or not options market makers are causing large numbers of fails in the equity securities markets, and its findings stand in stark contrast to the statements and arguments made by SIFMA, the CBOE and others acting as agents for options market makers. The OEA analysis definitively concludes that options market makers are responsible for a large and ever-growing numbers of FTDs in equity securities [7]. Thus, we strongly urge the commission to act accordingly, as it has promised to do, and eliminate the options market maker exemption from its regulatory scheme completely, and enforce 15c6-1 - the settlement cycle rule - and 15c3-3, the customer protection rule.

Further reasons why the options market maker exemption should be eliminated are listed numerically below.

1. Rule 15c6-1 Still Applies As It Has Not Been Exempted

When the Commission proposed and adopted REG SHO, the settlement date delivery requirement of 15c6-1 (the settlement cycle rule) was not changed, amended or exempted in any way. 15c6-1 also does not contain any exemption or provision for intent. REG SHO contains no language that exempts or pre-empts 15c6-1. This means that "intent" is not a defense when violating the settlement date delivery requirements of rule 15c6-1. The plain text of the rule is clear. REG SHO, since it has far less restrictive delivery requirements than 15c6-1, adds nothing new in the way of mandatory delivery requirements. 15c6-1 always applies first.

A layman analogy would be that REG SHO is akin to adopting a rule limiting trucks to a speed of 75 mph, even though there is already a speed limit of 55 mph on the books. What purpose would the 75 mph speed limit serve? REG SHO is much like this example - a less restrictive rule for delivery of securities than the already existing rule, without exempting the stricter rule in any way. It is nonsensical, unless the Commission actually intended to suspend or exempt 15c6-1, in order to apply the more liberal delivery requirements in REG SHO. But that was never proposed, and is absent in the final rule, thus REG SHO's delivery requirement is merely a meaningless caveat to the existing scheme of federal securities laws.

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The fact that the Commission and the rest of the world are looking at the number of FTDs published on the Commission's own website, and which the Commission is doing nothing to reduce except for pointing to REG SHO, forces one to conclude that the Commission has decided not to enforce 15c6-1, or at least to enforce it in a manner materially differently than as written - as all FTDs are a violation of the settlement date delivery requirements of 15c6-1. Touting REG SHO as a Commission enforcement action against FTDs completely obfuscates the Commission's obvious failure to enforce 15c6-1. It's like claiming to enforce the 75 mph rule for trucks, while not enforcing the 55 mph rule. Nothing in the plain text of REG SHO legitimizes the violation of the settlement cycle rule of 15c6-1, nor exempts it.

While the Commission has stated that failure to deliver securities by T+3 does not violate the settlement cycle rule 15c6-1, that statement, though true, is misleading because it infers that the settlement date delivery requirement is always T+3, when that is not the case [8]. Two parties to a trade could agree to delivery on, say, T+6, at the time of the transaction, and then the settlement cycle would legitimately be extended.

The settlement date delivery requirement is not determined by T+3. However, an FTD is always a violation of the settlement date delivery requirement. The Commission's statement is neither a complete nor an accurate description of 15c6-1, and 15c6-1 is not actually exempted. Most deliveries outside of T+3 generally do violate 15c6-1, but not all, as most trades do not have a prior arrangement to settle beyond T+3.

Left unexplained is why 15c6-1 is seemingly exempted by the Commission's authorization to permit FTDs, to varying degrees, replaced by the "close out dates" per REG SHO instead, despite the fact that FTDs are not legally defined. One would think that at the very least, a legal definition of FTDs would be a pre-requisite to their regulation [9].

It is also misleading to describe REG SHO as having "heightened delivery requirements"[10]. Because in fact, REG SHO's "heightened delivery requirements" are less restrictive than the much tighter "settlement date delivery requirements" contained in rule 15c6-1.

How can the Commission explain the purpose of the weaker "close out and delivery requirements" in REG SHO in light of the already existing stronger "settlement date delivery requirement" in 15c6-1? Or perhaps one should ask, what remains of 15c6-1 in the mind of the Commission after adopting REG SHO? Is REG SHO an expression of the Commission's intent to not enforce the "settlement date delivery requirement" anymore? Or to exempt 15c6-1 in some way, to be replaced with REG SHO's "close out requirement"? The way things stand now, it requires a degree of clairvoyance to determine the Commission's regulatory intentions.

To assist and ensure enforcement of 15c6-1, we suggest the Commission adopt a new provision, namely the automatic breaking of all failed trades and returning the purchase money to the original buyers unprompted and promptly. This would make 15c6-1 self enforcing and make new fails impossible. Thus way, the Commission could ensure market wide compliance with 15c6-1 with very few resources. What could be simpler and cheaper for all parties?

We also respectfully request that the Commission be responsive to our questions below:

Since the adoption of REG SHO in 2004:

- Did the Commission at any time intend to - or in fact did it - exempt 15c6-1 in any way?
- Did the Commission change enforcement of 15c6-1 in any way?
- Why has the Commission not addressed 15c6-1 in the plain text of REG SHO?
- Why has the Commission not disclosed or discussed any changes to 15c6-1 in the Commission's regulatory scheme?

2. Rule 15c3-3 Still Applies As It Has Not Been Exempted

Similar questions arise regarding the commission's intentions regarding rule 15c3-3 and what role 15c3-3 now plays in the Commission's regulatory scheme, post adoption of REG SHO**.** While 15c6-1 deals with the mandatory "settlement date delivery requirements", in contrast, 15c3-3(b)(1) and 15c3-3(b)(2) deal with ensuring that the securities are obtained by the brokers and that they do everything possible to ensure they obtain and maintain them. If they do not obtain the securities by settlement date, then 15c3-3 requires brokers act promptly to do all possible to go out and obtain them in good faith. Failure to do so puts them in violation of 15c3-3(b)(1). It's like a rule in addition to the speed limit, mandating drivers to promptly slow down to within the speed limit if they notice they are speeding.

In addition, if the nature of the failure to obtain securities is more than temporary in nature, as persistent "fails to receive" are, then rule 15c3-3(b)(1) is violated [11]. The manner in which REG SHO is applied in the Commission's regulatory scheme, suggests that the Commission either pre-empted, exempted, amended or no longer enforces 15c3-3(b)(2). In some major way, the Commission has changed the role of 15c3-3, without changing the plain text English of existing rules nor publicly disclosing the change. [12]. We contend that the Commission has exceeded its statutory authority by changing the role of 15c3-3 in this manner.

The options market makers exemption, by causing "fails to deliver", causes persistent "fails to receive" [13] to be carried on the books of broker-dealers. The number of "fails to receive" held for customers as a result of "fails to deliver" poses a huge systemic risk. The cost to close out those "fails to receive" and deliver the securities owed to customers could be in the trillions of dollars already. It's time to stop making the situation worse.

15c3-1, 15c3-2 and 15c3-3 require the safekeeping of customer assets and securities - not the creation of a fractional reserve type system, where a "run on the broker-dealer" can result in systemic failures like with Bear Stearns.

The fact remains that the Commission has not formally exempted 15c3-3. Instead, there appears to have been a "de facto" exemption of the rule, which is wholly unauthorized in federal securities law. When the Commission adopted the grandfather exemption, that act was an indication that the Commissions intended to exempt 15c3-3 and 15c6-1 in some way, since the grandfather exemption authorized brokers to maintain certain persistent fails as open positions for long periods of time, contrary to what 15c6-1 and 15c3-3 mandate.

The Commission's actions have severely undermined the markets' integrity, by removing their fundamental underpinnings, and by misleading many as to what the Commission's real regulatory scheme is. The Commission's silence over 15c6-1 and 15c3-3 contributes to this confusion.

Due to the conflicts with 15c3-3, we request that the Commission completely eliminate the options market maker exemption and enforce 15c3-3. Even if the Commission intends to keep 15c3-3 in full force, the options market makers exemption effectively renders 15c3-3 useless, as it makes it virtually impossible for broker-dealers to comply with the requirements of 15c3-3. Should broker-dealers attempt to buy-in the "fails to receive" produced as a result of "fails to deliver", the buy-ins can result in yet more "fails to receive" as the options market makers repeatedly "fail to deliver" their trades in that security. The market maker exemption destroys the utility of 15c3-3.

In addition to eliminating the options market maker exemption, we again respectfully request that the Commission address these issues, in a public release, and be responsive to our questions:

Since the adoption of REG SHO in 2004:

- Did the Commission at any time intend to - or in fact did it - exempt 15c3-3 in any way?
- Did the Commission change enforcement of 15c3-3 in any way?
- Why has the Commission not addressed 15c3-3 in the plain text of REG SHO?
- Why has the Commission not publicly discussed 15c3-3 in relation to REG SHO?
- If the Commission does not wish to discuss 15c3-3 publicly, why not?

3. REG SHO Unfairly Discriminates – Proscribed in Section 6(b)(5) of the SEA of 1934

The evidence is clear that the options market maker exemption unfairly discriminates against equity securities investors. In light of Section 6(b)(5) of the Securities Exchange Act of 1934, limiting the Commission's authority in this regard [14], it is imperative for the Commission to discuss and examine whether REG SHO or the options market maker exemption is unfairly discriminatory. In the absence of any publicized analysis or discussion on this topic, at the very least, the Commission needs to disclose why it feels it to be unnecessary to discuss and publicize this aspect of the exemption. If the Commission has not already done so, we request that a complete analysis be conducted by the Commission and made public. This public analysis is necessary, because it is clear to just about everyone else but the Commission [15] that the options market maker exemption is unfairly discriminatory, and thus prohibited by Section 6(b)(5) of the Securities Exchange Act of 1934.

Because of the discriminatory effect of the market maker exemption, it must be eliminated. The Commission has stated that the main beneficiaries of the rule are options markets: ***"The options market maker exception was created to address concerns regarding liquidity and the pricing of options." – Release No. 3456213***. Since the Commission is discussing the beneficiaries publicly, why does the Commission not complete the picture and discuss those who are adversely affected?

The Commission exceeded its statutory authority granted under the Securities Acts when it adopted the options market maker exemption, because the Commission is limited in its plenary authority by being proscribed from including unfair discrimination [16] in its regulatory scheme.

We request that the Commission be responsive to our questions below in a public release:

With the adoption of REG SHO in 2004:

- Was Section 6(b)(5) of the Securities Exchange Act of 1934 exempted or pre-empted in any way?
- Did the Commission consider the prohibitions in Section 6(b)(5) of the Securities Exchange Act of 1934 in any way?
- Why has the Commission not publicly discussed any unfair discriminatory effects of REG SHO towards equity security investors and equity security issuers?
- If the Commission has not or will not discuss the discriminatory effects of REG SHO publicly, why not?

In case the Commission has not considered the discriminatory effects of REG SHO, we request the Commission conduct such a study and make public the analysis in a public release.

4. The Commission Did Not Consider the Cost To Equity Investors And Issuers

The Commission asks in its proposed rule making: *"We seek comment about any other costs and cost reductions associated with the proposed amendment or alternative suggestions."* For one, the very brief Cost Benefit Analysis that was published by the Commission completely ignores the costs to equity securities investors and to equity security issuers. REG SHO and the "options market maker exemption" in particular, cost equity securities investors, issuers, their employees and their customers far more in aggregate, than the benefits the derivative market participants or derivative market makers can ever receive [17]**.** The options market maker exemption creates a huge net negative cost, when every affected party is taken into account [18].

Since all market participants were able to comply with the emergency order within one week [19] – the difficulty and cost to comply with an elimination of the options market maker exemption in REG SHO should be very reasonable, and will certainly cost a lot less than the current cost to equity security investors and issuers. Based on a cost benefit analysis, it should be a simple decision for the Commission to eliminate the options market maker exemption [20]. The simplest and best way to reduce the enormous cost burden thrown onto the equity securities markets is to eliminate the options market maker exemption. Derivative markets need to solve their liquidity issues while appropriately valuing the derivatives, without any hidden subsidy by equities investors as is the current scheme.

Besides eliminating the options market makers exemption, we request that the Commission be responsive to our questions in a public release:

With the adoption of REG SHO in 2004:

- Did the Commission do a cost benefit analysis of REG SHO from the point of view of equity securities investors and equity securities issuers in any way?
- Why has the Commission not publicly discussed a cost benefit of REG SHO from the point of view of equity securities investors and equity securities issuers?
- If the Commission has not or will not conduct a cost benefit analysis of REG SHO from the point of view of equity investors and issuers and release the analysis publicly, why not?

In addition, we request that if the Commission has not conducted a REG SHO cost benefit analysis from the point of view of equity investors and issuers, that the Commission conduct one and disclose the results and analysis via a public release.

5. The Commission Promised To Act If REG SHO Did Not Operate As Planned

Since the Commission promised, in the Adopting Release to REG SHO, that it would monitor the operation of Regulation SHO and would take into consideration any information that the options market maker exception was operating significantly differently from the Commission's original expectations [21], we ask that the Commission now act as promised. The only possible course of action, based on the information provided by the OEA analysis and based upon the Commission's stated goals, is the complete elimination of the options market maker exemption, since they are a major source of persistent fails. As early as in August 2007, even before the OEA analysis was available, the Commission had already admitted to major problems with the options market maker exemption, as noted in Release No. 34-56213 [22]:

> *"….the language of the current exception is being interpreted more broadly than the Commission intended, such that the exception seems to be operating significantly differently from our original expectations."*

Further Suggestions

The Commission asks in the release [23] for alternative proposals or suggestions, and we are pleased to do so. These are listed below.

I. The Commission Has Not Released Empirical Data On The Benefits Of Short Selling

The Commission has repeatedly stated that short selling provides the market with at least two important benefits: market liquidity and pricing efficiency. However, the only source the Commission has ever provided for this theory is a book: Lamont, Owen A. and Thaler, Richard H, 2003, *Can the Market Add and Subtract? Mispricing in Tech Stocks Carve-outs*, University of Chicago [24].

We hope that the Commission has more than just one book to fall back on to substantiate these theoretical "benefits" to **equity** markets. Especially since the Commission has built its entire

regulatory scheme, including REG SHO, around the assumption that short selling is beneficial to price discovery and liquidity in **equity** securities. We assume the Commission has empirical data to support this position. One book is scarcely enough of a foundation for the Commission to build a regulatory scheme upon, especially a book released in 2003.

The book that the Commission cities to support its belief, is mostly about the effect of the costs of short selling on arbitrage opportunities and the cost of short selling itself. It is not about the benefits to the price discovery in equity securities because of short selling or naked short selling.

It appears that the Commission considers limited supply and scarcity of securities a bad thing. We contend however, that scarcity and limited supply is an essential market ingredient to the proper price discovery. It is established economic theory. Distorting either the demand or the supply will always distort the price. Short selling and naked short selling changes the supply by increasing the number of shares in investor accounts to a number greater than the issuer has issued. There is no economic theory that does not contain supply and demand as essential factors in price discovery. SIFMA and others, that claim short selling helps price discovery, ignore accepted economic theory. They attempt to relate liquidity with price discovery and other benefits to equity markets. However, just because short selling does produces liquidity does not mean liquidity helps price discovery or anything else. More liquidity is just more liquidity. The Commission needs to focus on the fact that there can be too much or the wrong kind of liquidity.

The Commission also has seemingly gone along with the notion that heavily shorted companies and those with a high number of "fails" are only getting what they deserve because they are poorly run companies. We contend that everyone needs to be treated equally. Otherwise, value investors will not invest in companies targeted by naked short sellers. Value investing will become a thing of the past.

If the Commission's assumptions about legal short selling are not accurate, the Commission's assumptions about illegal short selling and naked short selling (legal and illegal) are inaccurate as well. In any case, the public has a right to know what the Commission is basing its regulatory scheme on and why the Commission believes and acts as it does when it comes to short sales. Therefore, we request that the Commission share the other empirical data that the Commission must surely have with the public as soon as possible, or alternatively explain why it is not sharing this information or why no such data exists, or why it feels no empirical data is necessary.

In particular, we request that the Commission be responsive to our questions in a public release:

- What is the basis for the Commission's belief that short selling provides beneficial price discovery and liquidity in equity securities?
- Is the Commission in possession of any empirical studies, data or information upon which the Commission has relied, to conclude that short selling provides beneficial price discovery and liquidity in **equity** securities?
- If the Commission is in possession of such other empirical information, why has the Commission not released it publicly?

- If the Commission feels that any, or more, empirical data is unnecessary, why?

In addition, we request that if the Commission is not in possession of any empirical data showing that short selling is beneficial for the price discovery and liquidity of equity securities, that the Commission conduct such a study and disclose the results in a public release.

II. The Commission Should Clarify Legal and Illegal Naked Short Sales

We do understand that there are legal naked short sales and illegal naked short sales. The legal naked short sales do not conflict with any statutes or rules – federal or state, and the Commission has the authority to permit them. However, the illegal naked short sales make up a majority – if not all - of the long term persistent fails and create the systemic risks.

Legal naked short selling is,

Selling a stock short, without locating or having it, but nevertheless delivering it on time within the settlement cycle – if, and only if, the short seller is exempt from the locate requirement.

Illegal naked short selling is,

1. If a short seller sells short without locating or having the security sold and is not exempt from the locate requirement, creating an illegal naked short sale, even if the security is delivered on time within the settlement cycle and does not create an FTD.

2. Selling a stock short and failing to deliver it within the settlement cycle delivery requirement (creating a "fail"), creates an illegal naked short sale – regardless of intent and regardless of whether or not the short seller is exempt from the locate requirement and regardless of whether or not the security is a threshold security.

   This is because delivering outside the legal delivery requirement defined in 15c6-1, **is always illegal**. There are no exceptions. The settlement cycle rule, 15c6-1, does not have any provision for "intent" nor does it have any exceptions for anyone, nor does REG SHO or any other rule exempt 15c6-1. Unless and until the Commission adopts a rule in plain text English, exempting rule 15c6-1, this settlement cycle rule will continue to apply to all trades and all market participants.

   To clarify, the Commission has stated that failure to deliver securities on T+3 does not violate the settlement cycle rule 15c6-1 [25]**,** and we concur with that statement. This is an accurate statement because 15c6-1 allows buyers and sellers to arrange for delivery after T+3 [26]. However, the persistent "fails to deliver" that everyone is concerned about have failed all legal delivery and settlement requirements.

The reading of the rules leads to no other conclusion as to the definition of legal and illegal naked short sales. However, apparently this is not how the Commission is interpreting the rules. That makes it imperative for the Commission to publicly explain and clarify why 15c6-1 and

15c3-3 are apparently not being enforced or being interpreted as the plain English text of the rules reads. The Commission has not issued any interpretive guidance nor any public release regarding this inconsistency between what the rules say and how the Commission seems to interpret them, and how it defines legal and illegal naked short sales.

Therefore, we request that the Commission be responsive to our questions in a public release:

- How does the Commission define legal and illegal naked short sales?

<u>III. "Fails To Receive" Are Worth Less Than The Securities They Replace</u>

Customers contract to buy real securities, not "fails to receive" securities. By obtaining mere "fails to receive" securities in lieu of the contracted for securities, customers and the markets are fooled and kept from seeing that securities of a lesser value and different nature are being obtained and maintained in the transaction. This is a deliberate and dangerous misrepresentation. By assigning higher values to the "fails to receive" than they actually are worth, customers are given a false sense of security and account balances. Who knows if in the future, the broker-dealers will be able to actually deliver the contracted for securities? Nobody is guaranteeing it. The systemic risk is when a large broker-dealer like Bear Stearns fails or even several of them. The funds provided by the SIPC would not even cover a fraction of the broker-dealer liabilities due to customers because of "fails to receive".

Chairman Cox admitted in a TV interview, that investment banks maintain only a fraction of customer assets. The foolishness of this, by broker-dealers, is seen in the sudden Bear Stearns meltdown. This also produces a systemic risk. Outside of the monetary Banking system, this must stop. The statutes that created the securities markets forbid a fractional reserve system for securities, like it is authorized in the banking system for U.S. Currency. Not for Securities.

A glimpse of the magnitude of the problem caused by crediting "fails to receive" to customer accounts is seen in the SIFMA report for NYSE broker-dealers. The latest report ending in Q1 2008, puts the market to market "fails to receive" liability for those broker-dealers at $140 billion.

Common sense says that the real cost and potential liability to deliver the undelivered securities would be a multiple factor higher than $140 billion. And that's only for this subset of broker-dealers. It is easy to see how the "fails to receive" liabilities of all market participants, ti buy and deliver all the securities owed, could top $1 trillion dollars.

Unfortunately, the firms, in aggregate, do not have the equity, capital or buying power to deliver on these obligations. Therefore, one could easily argue that the market participants in the U.S., in aggregate, are insolvent [27]**.** At the very least, with the firms in such a precarious position due to the "fails to receive" liabilities, we urge the Commission to stop firms from taking on any more such liabilities and misrepresenting customer securities and accounts.

The only way to accomplish this is to stop "fails to deliver" first, these cause "fails to receive". If "fails to receive" did not have the habit of accumulating over time, the liabilities would never have reached these levels. Unfortunately, these high levels are destabilizing, and have grown to such size that they are now a systemic risk all by themselves.

The economic reasons to stop all fails (receive and deliver) should be compelling enough. The legal reasons are another reason. "Fails to Receive" are not defined in securities laws. If the requirements of rules 15c6-1 [28], 15c3-3 [29] and UCC § 8-504 [30] and § 8-102 (a) (15) [31] were enforced – "fails to receive" securities would not be carried in any meaningful numbers nor for any meaningful periods of time by broker-dealers at all, and certainly never credited to customer accounts in lieu of the contracted for customer securities. "Fails to Deliver" should never be present in large number in OTC securities [32], however this unfortunately is the current case [33].

Since many (though not all) "fails to deliver" cause "fails to receive" liabilities, and the historical trend is that "fails to receive" liabilities accumulate (how else would we be where we are today), for the sake of the integrity of the entire financial market, we urge the Commission to stop all "fails to deliver" and clean up "fails to receive". One of the first steps in this direction would be the elimination of the market maker exemption and the documentation of locates as proposed under the amendment to rule 200(g). A second step would be for the Commission to figure out a long term plan to clear out the long-term liabilities represented as "Fails to Receive". Grandfathering them in, however, would not be one of the better ideas. We believe the Commission has already tried that, with less than stellar results. "Fails to Receive" liabilities cannot remain indefinitely, or keep increasing, without breaking the system at some point.

In summary, we urge the commission to

1. Stop all FTRs and FTDs
2. Collect, Analyze and Monitor Fails to Receive Data
3. Formulate a long term plan to eventually eradicate all FTR liabilities
4. Make the FTR data public on a per issue basis like the FTD data is currently released
5. Report violations to REG T to the FED

Due to the regulatory issues and the systemic risks associated with FTRs, and the misrepresentations made to markets and customers, we feel the Commission should at least be responsive to the question below in a public release:

- Why does the Commission not publicly release Fails to Receive data regularly?
- Why does the Commission tolerate billions of dollars of "fails to receive" liabilities?
- Is it the Commission's position that "fails to receive" securities can be maintained for customers by broker-dealers in lieu of the contracted for securities?
- Why does the Commission not have a close out rule or policy for "fails to receive"?

IV. The Solution Is Simple

1. Enforce 15c6-1 and 15c3-3 Market wide
   The Commission's emergency order was the right thing to do and the results speak for themselves. All that remains is to extend it permanently market-wide to all securities. New rules are not required. All it would take is for the Commission to start enforcing 15c6-1 and 15c3-3 and very long list of other existing rules and new fails would stop. We urge the Commission not to succumb to market makers or other special interests by doling out exemptions. The rules need to be enforced equally without exception. Creating exemptions is exactly what got us where we are today, in addition to oftentimes violating Section 6(b)(5) of the Securities Exchange Act. There is a well established lending market where securities can be borrowed, if necessary. Market participants could easily comply, as seen with the speed with which the emergency order was complied with. The Commission could ensure compliance by requiring that all failed trades be broken.

2. Long Term Plan To Close Out "Fails to Receive" Securities
   It makes little sense to attempt cleaning up persistent fails if new ones are not stopped. However, merely stopping new fails does not address the billions of older fails that market participants are already liable for. This will require a long term clean-up plan. The securities markets should not be built upon a foundation of "fails to receive" and "fails to deliver". Customer assets and securities need to be maintained in reality and safely and not replaced with "fails to receive" or other virtually worthless securities.

The Commission has seen the systemic danger in the current regulatory scheme and acted by enforcing the existing **settlement date delivery requirement** and requiring a pre-borrow for short sales in 19 securities. Section 6(b)(5) of the Securities Exchange Act of 1934 requires equal treatment, therefore the Commission should apply this remedy to all securities, not just the 19 selected. Especially since there are many securities that have been battered by fails far worse than those select 19 securities [34].

Conclusion

NIPC is not alone in demanding much more reliable settlement of securities than currently is the case. The U.S. Chamber of Commerce, the American Banker's Association, the Coalition of Private Investment Companies, and many issuers and investors have written the Commission to extend the provisions of the emergency order to all securities [35] and eliminate "fails" of all kinds from the securities markets. We suggest enforcing this by requiring all failed trades be broken [36].

Extending the provisions of the emergency order to the broad market without any exemptions would eliminate the options market maker by default and fix many of the problems and conflicts mention in this letter. Therefore we strongly urge the Commission to enforce 15c6-1 and 15c3-3 and require a pre-borrow for short sales in all cases and without any exemptions. The securities lending market can handle the great majority of borrowing needs. What it can not handle is the natural limit and market scarcity. Scarcity and limited supply are essential market ingredients.

We also suggest that the Commission answer the questions we posed in this letter in a public manner due to the conflicts within the Commission's regulatory scheme. If the Commission decides not to respond, we feel the Commission should at the very least publicly state why not.

Our rule petition to the Commission [37], has many more details on rule conflicts, detailing how the Commission is exceeding its statutory authority and the secret nature of the "rules". There as here, we ask for answers and clarity rather than a regulatory scheme concocted in a manner hidden from the public. We ask the commission to consider the solutions proposed in our rule petition as it discusses removing all fails. We would like the commission to very carefully consider adopting a rule that requires breaking all failed trades, as this would simplify matters and ensure compliance with 15c6-1. It would also link settlement with clearing, as mandated by the U.S. Congress. A copy of the petition is attached as exhibit "A".

Additional data is also found in an academic study which shows the size of all "fails" to be much larger that the DTCC publicly discusses [38]. The securities markets have become a house of cards shaking precariously due to the persistent fail obligations and price manipulations of individual securities via fails. Settlement of trades is the most basic function in any market. This is not something investors or issuers should have to beg for.

Erik Sirri, *Director, Division of Trading and Markets,* May 9, 2008, SIFMA conference:

> "The Exchange Act requires that the national securities exchanges operate in the public interest. In 1934, for example, Congress emphasized that the exchanges are *"public institutions which the public is invited to use for the purchase and sale of securities,"* and are not *"private clubs to be conducted only in accordance with the interests of their members."* Clearly, this congressional imperative must be respected. To pass muster under the Exchange Act, an exchange initiative should not merely advantage its own competitive interests or those of its liquidity providers at the expense of public customers, in the absence of a good reason to believe that the public ultimately will benefit from more efficient trading."

We hope that the Commission respects the Congressional imperatives outlined by Dr. Sirii, as currently, that is not the case. Section 17a of the Securities Exchange Act of 1934 [39] explicitly directs the Commission regarding the settlement of trades and many wonder why the Commission's regulatory scheme does not reflect the clearly expressed will and intent of U.S. Congress. If the Commission feels it needs to follow a different path, then the Commission must inform the public and the U.S. Congress openly, completely and clearly.

Sincerely submitted,

Thomas Vallarino

President, National Investor Protection Coalition

[1] See OEA MEMORANDUM, June 9, 2008:
"… fails to deliver in optionable securities increased significantly…….One explanation of these results is that the investors who previously failed to deliver in the equity market have now moved to the options market to establish a synthetic position." http://sec.gov/comments/s7-19-07/s71907-562.pdf

[2] **RELEASE NO. 58166 / July 15, 2008** http://sec.gov/rules/other/2008/34-58166.pdf

[3] From the emergency order, **Release No. 58166:**
"…loss of confidence can lead to panic selling, which may be further exacerbated by "naked" short selling. As a result, the prices of securities may artificially and unnecessarily decline well below the price level that would have resulted from the normal price discovery process."

"…the Commission has concluded that there now exists a substantial threat of sudden and excessive fluctuations of securities prices generally and disruption in the functioning of the securities markets that could threaten fair and orderly markets."

[4] See NCANS comment re: Release No. 34-54154, dated Sept 18, 2006, with over 1,000 individual signatures :

"For the sake of market integrity, investor protection, and the reputation of U.S. markets, SEC rules need to align with the requirements of the Securities Act of 1933, the 1934 Securities Exchange Act, U.C.C. Article 8, state securities laws, and international securities exchange standards. We believe the U.S. equities markets cannot function properly unless the SEC's rules are consistent with their fundamental principles: namely, for the prompt delivery of genuine securities *in all cases*; for even application of rules and law across *all* investor and participant types;.." http://sec.gov/comments/s7-12-06/mhelburn5381.pdf

[5] The settlement date delivery requirement is defined in the settlement cycle rule, 15c6-1. The emergency order, with a simple statement for market participants to adhere to 15c6-1, established order in those 19 securities again:

Release No. 58166 "……..and delivers the security on settlement date."

Release No. 58190 "…(The settlement date delivery requirement of the Order applies to these market makers.)"

Despite the fact that the pre-borrow requirement was later substantially watered down, the emergency rule has been very effective in reducing naked short sales in the securities covered by the emergency order. This is because equity market makers and options market makers were exempted from the pre-borrow requirement by an amendment to the order on July 18 2008 – just 3 days after the original order. However, the settlement date delivery requirement, as legally defined in the settlement cycle rule, remained and applied to everyone. This is the only provision of the emergency order that universally applies.

[6] **REG SHO rule 203 (b)(iii)** already mandates proper documentation of "locates" :
"(iii) Documented compliance with this paragraph (b)(1)"

[7] See OEA MEMORANDUM, June 9, 2008:
"Since the option market makers still enjoy an exception to the close-out rule and tend to hedge their positions in the equity markets, the fails may now be coming from the option market makers instead of the equity investors themselves."

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[8] Rule 15c6-1: "…….a broker or dealer shall not effect or enter into a contract for the purchase or sale of a security………….. **unless otherwise expressly agreed to by the parties at the time of the transaction**." (emphasis added). The legal settlement date can beyond of T+3 in certain cases. However, when an FTD is issued, the security is not delivered by the settlement date delivery requirement, even if that date was beyond T+3.

[9] **Securities Exchange Act Release No. 56213 (August 07, 2007) ("Amendments to REG SHO")**
"We have previously noted that abusive "naked" short selling, *while not defined in the federal securities laws* generally refers to selling short without having stock available for delivery and intentionally failing to deliver stock within the standard three day settlement cycle." (emphasis added).

To legally define FTDs and FTRs as legitimate securities, the Commission would need the cooperation of all 50 states and an amendment to the UCC to accomplish this, as only the states have jurisdiction over the form of securities. We suspect that this is the real reason why the Commission has made no attempt to legally define "fails to deliver" and "fails to receive" and avoids talking about 15c6-1. What it means however, is that the SEC is trying informally and deliberately implement a rule which exceeds the Commission's statutory authority to unilaterally implement and without public adoption.

[10] **Release No. 34-50103** : "Rule 203….imposes heightened delivery requirements on securities that have fails to deliver,…" - Release No. 34-50103

Release No. 34-48709 : "Proposed Regulation SHO would………..,impose strict delivery requirements on securities where many sellers have failed to deliver the securities."

[11] 15c3-3(b) reads as follows (emphasis added):

Physical possession or control of securities.

1. A broker or dealer shall **promptly obtain and shall thereafter maintain** the physical possession or control of all fully-paid securities and excess margin securities carried by a broker or dealer for the account of customers.

2. A broker or dealer shall not be deemed to be in violation of the provisions of paragraph (b)(1) of this section regarding physical possession or control of customers' securities if, solely as the result of normal business operations, **temporary** lags occur between the time when a security is required to be in the possession or control of the broker or dealer and the time that it is placed in his physical possession or under his control**, provided that the broker or dealer takes timely steps in good faith to establish prompt physical possession or control**. The burden of proof shall be on the broker or dealer to establish that the failure to obtain physical possession or control of securities carried for the account of customers as required by paragraph (b)(1) of this section is merely temporary and solely the result of normal business operations including same day receipt and redelivery (turnaround), and to establish that he has taken timely steps in good faith to place them in his physical possession or control.

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[12] The Commission leaves the impression that 15c3-3 is exempted by making statements such as these about REG SHO: *"The exception does not require that such fails be closed out within any particular timeframe." And, "Regulation SHO does not require close outs of non-threshold securities."* This is contrary to what 15c3-3 requires.
This flies in the face of the fact that 15c3-3 and 15c6-1 both apply to all securities, threshold or not, and positively do require securities to be delivered by the settlement date and to "promptly" go out and obtain them should delivery by settlement date fail. The Commission's is conferring authority onto REG SHO that it can not have, without exempting 15c6-1 and 15c3-3 first.

[13] In Q1 2008, SIFMA reported that NYSE broker-dealers carried liabilities totaling over **$140 billion USD in "Fails to Receive".** If 15c3-3 were enforced, these obligations would not exist. Rather these SIFMA broker-dealers would quickly go out and buy-in or otherwise obtain the "fails to receive" for their customers, as 15c3-3 requires. In addition, "fail to receive" are not even defined in securities laws, so their value can not be accurately determined. It can only be surmised that $140 billion in undelivered securities valued via market-to-market accounting would cost much more than $140 billion to buy-in and deliver. This systemic risk is the reason why 15c3-1,15c3-2and 15c3-3 were adopted. By not enforcing these rules and allowing broker-dealers to carry undefined securities on the books, the Commission is allowing the systemic risk to grow into trillion dollar proportions.

[14] **Section 6(b)(5) of the Securities Exchange Act of 1934**: "*The rules of the exchange are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest; and are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers, or to regulate by virtue of any authority conferred by this title matters not related to the purposes of this title or the administration of the exchange."*

[15] See the hundreds of comment letter to the SEC by investors and issuers expressing this view in their letters

[16] Section 6(b)(5) of the Securities Exchange Act of 1934 expressly prohibits the SEC from adopting rules that unfairly discrimination between customers, issuers, brokers or dealers.

[17] The price erosion of equity securities of just one company, like Bear Stearns, can **cost** equity security investors billions of Dollars over a very short period of time. Not to mention the cost to the company, the employees and their customers. Another example is Force Protection (NASDAQ: FRPT), which could not raise the capital to open another factory, due to naked short sellers hammering the price of their securities. The capital was intended to ramp up production of blast resistant vehicles used by the US Military in Iraq. The inability to ramp up production has certainly cost the lives of US Military personnel. People have died because the Commission's regulatory scheme shifts enormous costs onto investors, issuers and their customers. This is also an example of the formation of capital being blocked – a stated goal of the Commission.

[18] The illegal naked shorting of companies like MBIA, FRPT, CALM, FFH, BSC and many others, have helped cause investors and issuers to lose billions of Dollars. This is well beyond any benefit that equity markets can receive in theoretically "beneficial" liquidity. It is also beyond the amount of benefit derivatives markets can possibly receive. There is an imbalance in the cost benefit, strongly tilted against equity markets.

[19] The Emergency Order was issued on July 15, 2008 and effective on July 21 2008 – 6 days notice

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[20] The Complete elimination of the options market maker exemption would be the simplest, cheapest and fastest solution. The options market makers would not have to keep track of the source or the reasons for any "fails to deliver" or associate them with anything. They would simply have closed out all "fails" out as quickly as possible, as 15c3-3 already requires them to. Perhaps a better question should be, what would the cost be to comply with 15c3-3 – a long overdue question that should not even have to be asked.

[21] Release No. 34-50103, July 28, 2004 http://www.sec.gov/rules/final/34-50103.htm#V

[22] Release No. 34-56213, August 07, 2007 http://www.sec.gov/rules/proposed/2007/34-56213.pdf

[23] Release No. 34-56213, August 7, 2007 http://www.sec.gov/rules/proposed/2007/34-56213.pdf
"With respect to any comments, we note that they are of the greatest assistance to our rulemaking initiative if accompanied by supporting data and analysis of the issues addressed in those comments and if accompanied by alternative suggestions to our proposals where appropriate."

[24] The Book was quoted in **Release No. 34-48709** - the proposal for REG SHO in October 2003, as the source of the Commission's belief that short selling has benefits by helping in price discovery and by providing liquidity.
http://www.sec.gov/rules/proposed/34-48709.htm#P179_15857

[25] Division of Market Regulation: Key Points About Regulation SHO, April 11, 2005
http://www.sec.gov/spotlight/keyregshoissues.htm "....it designed and adopted Rule 15c6-1 to prohibit broker-dealers from contracting to settle transactions later than T+3. However, failure to deliver securities on T+3 does not violate the rule." This does not accurately describe 15c6-1

[26] Rule 15c6-1: ".......a broker or dealer shall not effect or enter into a contract for the purchase or sale of a security (other than an exempted security, government security, municipal security, commercial paper, bankers' acceptances, or commercial bills) that provides for payment of funds and delivery of securities later than the third business day after the date of the contract **unless otherwise expressly agreed to by the parties at the time of the transaction**." (emphasis added)

[27] The firms report $117 billion in accounts receivable due to "fails to deliver". However the value of the "fails to deliver" will not increase, where as the cost to clear the liabilities caused by the "fails to receive" will surely be much higher than the current market to market liability. No wonder the market participants argued for the grandfather exemption for their fails.

One can see that they're hanging by a shoe string by their own aggregate numbers:

Total Assets	**5,564,248.4**
Total Liabilities	**5,455,725.0**
TOTAL OWNERSHIP EQUITY	**108,523.4**
TOTAL NET CAPITAL	**101,853.0**

The real cost to clear out the "fails to receive" would exceed the total ownership equity and net capital of this group. They simply can not make good on their liabilities unless they raise hundreds of billions of dollars in additional equity. Buying-in and attempting to deliver will increase the price of the securities, increasing the costs way beyond the current market-to-market amount.

[28] The settlement date delivery requirement – The settlement cycle rule

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[29] The Customer Protection rule requiring brokers to promptly obtain and safely maintain securities

[30] § 8-504. DUTY OF SECURITIES INTERMEDIARY TO MAINTAIN FINANCIAL ASSET
"A securities intermediary shall promptly obtain and thereafter maintain a financial asset in a quantity corresponding to the aggregate of all security entitlements it has established in favor of its entitlement holders with respect to that financial asset."

[31] "Security," except as otherwise provided in Section 8-103, means an obligation of an issuer or a share, participation, or other interest in an issuer or in property or an enterprise of an issuer:"

Who is the issue "Fails to Receive" securities"? Are these the issuers customers pay to receive an interest in?

[32] Large numbers of FTD in OTC securities can be assumed to be converted into "fails to receive" liabilities in OTC securities, which the FED's REG T and the reserve requirements for those type of securities prohibit.

[33] Many OTC securities are on the REG SHO list, such as NOVS and NOVSP

[34] There are many securities that are not one of the 19 covered by the emergency order, that, unlike the 19, have been on REG SHO for months and years with a far larger percentage of fails than the 19. In fact, nearly 7,000 companies have appeared on the Threshold Securities List, with nearly 700 companies appearing for over 100 trading days. These securities need an emergency order far more urgently than the 19 the Commission selected.

[35] http://sec.gov/comments/s7-20-08/s72008-28.pdf U.S. Chamber of Commerce Letter
http://sec.gov/comments/s7-20-08/s72008-140.pdf American Banker's Association Letter
http://sec.gov/comments/s7-20-08/s72008-30.pdf Coalition of Private Investment Companies Letter

[36] This would cost the Commission very few resources, since it is self enforcing. All failed trades are cancelled out.

[37] http://investorprotectioncoalition.org/files/NIPC_SEC_Rule_Petition.pdf or
http://sec.gov/rules/petitions/2008/petn4-557.pdf SEC file number 4-557 under rule petitions

[38] http://papers.ssrn.com/sol3/papers.cfm?abstract_id=849224
"*For example DTCC estimates that 5% of secondary market trades fail to settle each day. With approximately $4.5 trillion of settlement value in 2004, failed transactions equal $ 225 billion* daily."

"*One of the problems in assessing how reliable, and hence safe, a market settlement system is concerns obtaining reliable data on such matters as failing transactions -- let alone ascertaining exactly where liabilities lie during the settlement and subsequent on-going custody of the assets. In the more advanced markets, such as those in the UK and the US, the local regulators have ensured that reliable transaction data is readily available in a very transparent manner. In these markets, when the depository advises that they have a fail rate of approximately 5% (in the case of DTCC) or approaching 1% in the case of CRESTCo in the UK, one can rely on such figures."*

"This research is supported by the DTCC white paper, which reports that 6% of institutional transactions being settled on an average day are expected to fail, while the fail rate on the market-side is lower at 4.4%."

The statements by the DTCC on fails vary considerably from these values. Perhaps the DTCC is already factoring in the mitigating effects of netting or the stock borrow program on "fails to receive".

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[39] Section 17a of the Securities Exchange Act of 1934:

Congressional findings; facilitating establishment of system

1. The Congress finds that--

    A. The prompt and accurate clearance and settlement of securities transactions, including the transfer of record ownership and the safeguarding of securities and funds related thereto, are necessary for the protection of investors and persons facilitating transactions by and acting on behalf of investors.

Subject: File No.
From: Thomas Vallarino
Affiliation: President, National Investor Protection Coalition

August 13, 2008

Exhibit "A" to the main comment can be downloaded from the SEC's own website at

http://sec.gov/rules/petitions/2008/petn4-557.pdf

Please attach and consider this link and entire file as Exhibit "A" to the main comment letter.

The upload can not successfully be completed, despite numerous attempts.